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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1972

No. 72-372

ROAD MATERIALS, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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The petitioner, Road Materials, Inc., respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fourth Circuit, entered in this proceeding on April 4, 1972.

OPINIONS BELOW

The Supplemental Memorandum Findings of Fact and Opinion of the United States Tax Court, T.C. Memo. 1971-170, filed July 20, 1971, appear as Appendix A

hereto, and are unofficially reported at 30 TCM 728 and ¶71,170 P–H Memo T.C. The per curiam opinion of the Court of Appeals, affirming the Tax Court, not yet reported, was entered on April 14, 1972, and appears as Appendix B hereto.

JURISDICTION

The judgment of the Court of Appeals for the Fourth Circuit was entered on April 4, 1972. The petitioner's Application for Extension of Time Within Which to File Petition for Writ of Certiorari was granted by the Chief Justice, by Order dated June 30, 1972, to and including September 1, 1972.

The jurisdiction of the Court is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED

Whether amounts totaling $497,265.83, which were advanced by the petitioner to Savage Construction Company, Inc., and which became completely worthless in 1963, are deductible for the taxable year ending November 30, 1963, as an ordinary loss as a result of the applicability of Section 165(g)(3), Internal Revenue Code of 1954, and Treasury Regulations promulgated pursuant thereto; and, specifically, whether at least 95 percent of each class of stock of Savage Construction Company, Inc., was owned directly by the petitioner within the meaning of Section 165(g)(3)(A), Internal Revenue Code of 1954.

STATUTES AND REGULATIONS INVOLVED

The statutory provision involved is Section 165(g) of the Internal Revenue Code of 1954.

The provisions of Treasury Regulations involved are those of §1.165-5.

The text of the provisions involved is set forth in Appendix C hereto.

STATEMENT OF THE CASE

The Court of Appeals, affirming per curiam on the opinion of the United States Tax Court, denied the petitioner an ordinary loss deduction of $497,265.83 under Section 165(g)(3) of the Internal Revenue Code of 1954.

The case involves the deductibility as an ordinary loss of amounts totaling $497,265.83, which were advanced by the petitioner to Savage Construction Company, Inc. (hereinafter referred to as "Savage") during the period from August 31, 1961, to August 31, 1963, which became totally worthless during the petitioner's taxable year ending November 30, 1963 (hereinafter referred to as "fiscal year 1963").

There is no doubt that there was an economic loss and that the entire loss occurred in fiscal year 1963; and the Commissioner of Internal Revenue has conceded this fact.

The only question is whether the worthlessness of the $497,265.83 advanced by the petitioner to Savage was an ordinary loss, due to the applicability of Section 165(g)(3) of the 1954 Code, or was a capital loss, in which case it would be entirely nondeductible, inasmuch as the petitioner had no gains from sales or exchanges of

capital assets in fiscal year 1963 (see Section 1211, 1954 Code).

When the case was first argued in the Court of Appeals, the petitioner asserted that its advances to Savage—if held not to be a bona fide debt—should be held to be an ordinary loss because its investment was in securities of an "affiliated corporation" within the meaning of Section 165(g)(3) of the 1954 Code.

The Court of Appeals, in its first decision, remanded the case to the Tax Court "to determine whether the loss from the capital contributions can be offset against ordinary income under Int. Rev. Code of 1954, Sec. 165(g)(3)" (*Road Materials, Inc. v. Commissioner*, 407 F.2d 1121, 1122 (4 Cir. 1969)). The Court of Appeals stated that (*id.*, 1125-1126):

> "This issue raises factual and legal questions that should be considered in the first instance by the Tax Court, and to that end we remand."

The Tax Court held that the amounts totaling $497,265.83 were not deductible as an ordinary loss, essentially on the ground that the petitioner did not own directly at least 95 percent of each class of Savage's stock within the meaning of Section 165(g)(3)(A) of the 1954 Code.

The Court of Appeals, without writing an opinion of its own, affirmed the denial of the ordinary loss deduction on the opinion of the Tax Court.

The earlier opinion of the Court of Appeals held squarely that the petitioner's advances to Savage constituted an investment of $497,265.83 in the capital stock of Savage (407 F.2d 1121, 1122). Under the statute, direct ownership of "a right to subscribe for, or

to receive, a share of stock in a corporation" is the equivalent of direct ownership of the stock itself, and there is no doubt that the petitioner possessed that right with respect to the capital stock of Savage (Section 165(g)(2)(B), 1954 Code).

The narrow issue presented, therefore, is whether the petitioner's contributions to the capital of Savage constituted an investment in the same class of stock as that which was originally issued to the individual stockholders—namely, common stock—or a different class of stock. If there was only one class of stock, it necessarily follows, from the undisputed facts, that the petitioner had the required 95 percent direct ownership of securities in an "affiliated corporation" to qualify for an ordinary loss deduction in fiscal year 1963.

It is essential to the consideration of this case to note that the petitioner's contributions to the capital of Savage were made by operation of law, namely, due to the original decision of the Court of Appeals that the advances in question did not create a bona fide debtor-creditor relationship. The investment in the capital stock of Savage, in other words, was entirely unrelated to the intentions of either the petitioner or Savage.

The petitioner urges that the decision of the Tax Court that Savage had more than one class of stock—in the absence of any evidence to that effect adduced by the Commissioner and in the face of Savage's Certificate of Incorporation clearly providing for only one class of stock, namely, common stock of the par value of $10 per share—was an arbitrary holding, altering and limiting the provisions of Section 165(g)(3), and interpreting such provisions entirely inconsistently with the liberalizing intent of the Congress in enacting such provisions.

By the same token, the per curiam affirmance of the Tax Court by the Court of Appeals represents an erroneous extension of that Court's power to interpret the revenue laws and constitutes an unauthorized invasion of the legislative function.

The undisputed facts of the case are as follows:

1. Petitioner was organized under the laws of the State of West Virginia on March 17, 1947, with its principal office at Bluefield, West Virginia. The returns for the period here involved were prepared on a fiscal year accrual basis ending November 30.

2. Petitioner timely filed its Federal Corporation Income Tax Returns, Form 1120, for the fiscal years 1958, 1959, amended return for 1959, 1960, 1961, 1962, and 1963 with the District Director of Internal Revenue at Parkersburg, West Virginia.

3. Petitioner timely filed Form 1139, "Application for Tentative Carryback Adjustment," requesting refund of tax in the fiscal years ended November 30, 1960, November 30, 1961, and November 30, 1962, as a result of a net loss claimed on the return for the fiscal year ended November 30, 1963.

4. The original Charter of petitioner provided for a total authorized capital stock of Fifty Thousand and no/100 Dollars ($50,000.00) divided into five hundred (500) shares at a par value of One Hundred and no/100 Dollars ($100.00) each. On November 22, 1955, the Charter was amended and the total authorized capital stock of petitioner was increased from Fifty Thousand and no/100 Dollars ($50,000.00) to Five Hundred Thousand and no/100 Dollars ($500,000.00) divided into a total of five thousand (5,000) shares at a par value of One Hundred and no/100 Dollars ($100.00) each.

5. The capital stock of petitioner is in the amount of Four Hundred Thirteen Thousand One Hundred and no/100 Dollars ($413,100.00) and represented by four thousand one hundred thirty one (4,131) shares with a par value of One Hundred and no/100 Dollars ($100.00). Said shares are owned by the following persons:

C.N. Haynes	2,821 shares
Hazel S. Haynes	1,280 shares
A.C. Haynes	30 shares
	4,131 shares

6. The officers of petitioner during the fiscal years 1958 to 1963, inclusive, were:

C.N. Haynes	President
A.C. Haynes	Vice-President
H.S. Haynes	Secretary-Treasurer

7. H.S. Haynes is the wife of C.N. Haynes and A.C. Haynes is the brother of C.N. Haynes.

8. Petitioner is a corporation engaged in a phase of the road construction business and during the years in issue was engaged in laying of stone base and asphaltic concrete, commonly described as black-top, on roads and highways.

9. HAYNES CONSTRUCTION COMPANY, INCORPORATED, a West Virginia corporation, was organized as Acme Concrete and Asphalt Company, a West Virginia corporation, on January 7, 1950. On October 13, 1956, the Charter of said corporation was amended and the name changed to HAYNES CONSTRUCTION COMPANY, INCORPORATED, and the principal office moved from Welch, West Virginia to Bluefield, West Virginia. The authorized capital stock of

the corporation at that time was increased from Fifty Thousand and no/100 Dollars ($50,000.00) to Two Hundred Thousand and no/100 Dollars ($200,000.00) consisting of two thousand (2,000) shares with a par value of One Hundred and no/100 Dollars ($100.00) each. Said shares were owned by the following persons during the years involved in this proceeding:

1958

C.N. Haynes, President	895 shares
Hazel S. Haynes, Secretary-Treasurer	5 shares
A.C. Haynes, Vice-President	300 shares
D.W. Jayne	300 shares

1959, 1960, 1961, 1962

C.N. Haynes, President	895 shares
Hazel S. Haynes, Secretary-Treasurer	5 shares
A.C. Haynes, Vice-President	300 shares
D.W. Janye	240 shares
J.J. Chase	60 shares

1963

C.N. Haynes, President	1,140 shares
Hazel S. Haynes, Secretary-Treasurer	5 shares
A.C. Haynes, Vice-President	300 shares
J.J. Chase	60 shares
Fred A. Moore	120 shares

10. HAYNES CONSTRUCTION COMPANY, INCORPORATED, (hereinafter HAYNES) was engaged in the road construction business and during the years in issue was primarily engaged in the grading of roads and highways and the laying of concrete thereon. The contracts were bid on a competitive basis. The

corporation was qualified to do business in the States of West Virginia, North Carolina, Tennessee, Virginia, and Kentucky.

11. SAVAGE CONSTRUCTION COMPANY OF BLUEFIELD, INC., is a corporation incorporated under the Laws of the State of West Virginia on March 3, 1960. The total authorized capital stock was Fifty Thousand and no/100 Dollars ($50,000.00) consisting of five thousand (5,000) shares at a par value of Ten and no/100 Dollars ($10.00) per share. The Certificate of Incorporation provides for only one class of authorized capital stock–described therein as "shares of the par value of Ten dollars each"–and the space beneath the following printed instructions on the Certificate of Incorporation form is left blank:

> "Use space below for statement as to stock without par value, or where more than one class of stock is to be issued, or one or more series within a class, * * *"

One thousand shares (1,000) of the value of Ten Thousand and no/100 Dollars ($10,000.00) were issued for cash to the following persons:

C.N. Haynes, President	490 shares
Hazel S. Haynes, Secretary-Treasurer	20 shares
A.C. Haynes, Vice-President	70 shares
J.J. Chase	70 shares
Haskell Savage	350 shares

12. When SAVAGE CONSTRUCTION COMPANY, INC., (hereinafter SAVAGE) was incorporated, C.N. Haynes advanced to it the amount of Ten Thousand and no/100 Dollars ($10,000.00). This advance was carried on the books of SAVAGE as a loan.

13. SAVAGE was engaged in the road construction business and during the years in issue was engaged in the grading of roads and highways. The contracts were bid on a competitive basis and required bid and completion bonds. All bids and work performed by this corporation were in the State of West Virginia and all bids were made jointly with HAYNES.

14. SAVAGE was formed as a separate corporation for the primary purpose of allowing Haskell Savage (hereinafter Mr. Savage), particularly competent superintendent of HAYNES whom C.N. Haynes wished to continue to employ, to acquire an interest in the heavy construction business which was principally owned by C.N. Haynes, without the investment by Mr. Savage of a large amount of capital. In addition to the $3,500.00 contributed to the capital of SAVAGE by Mr. Savage, a total of $6,500.00 was contributed to such capital by C.N. Haynes and three other shareholders; and C.N. Haynes also advanced to SAVAGE the amount of $10,000.00, which was carried on the books of SAVAGE as a loan.

15. When SAVAGE was formed, it was intended that SAVAGE would bid on interstate and other highway work in West Virginia within the supply range of petitioner's asphalt plant, and that petitioner would be doing the stone base, resurface and asphalt paving on jobs thus bid by SAVAGE, receiving a profit therefor. This plan, however, had to be abandoned because of losses sustained by SAVAGE on other contracts, due to the illness of Mr. Savage and continuous rain during the operating season in the years 1961 and 1962, and difficulties with governmental agencies regarding the interpretation of specification requirements.

16. Although HAYNES and SAVAGE jointly bid on seven contracts, beginning in 1960 to 1962, there were no bids made jointly by SAVAGE and petitioner, due to the facts set forth in paragraph 15, above.

17. During the period from August 31, 1961, to August 31, 1963, petitioner advanced to SAVAGE amounts totalling $497,265.83, which were shown on the books of petitioner as loans. In making these loans to SAVAGE, petitioner intended and expected to be repaid. These loans were made for the purpose of enabling SAVAGE to purchase equipment and carry on operations.

18. During the period from December 31, 1960, to December 31, 1963, HAYNES advanced to SAVAGE amounts which totaled (after crediting to SAVAGE cash transfers, contract income collected by HAYNES on behalf of SAVAGE, etc.) $846,781.49, and which were shown on the books of HAYNES as loans.

19. During the period from February 28, 1957, to November 30, 1963, petitioner advanced to HAYNES amounts which totaled (after crediting to HAYNES repayments, equipment rental charges paid by HAYNES, tax liability of petitioner paid by HAYNES, etc.) $415,607.79, and which were shown on the books of petitioner as loans.

20. No notes or other instruments of indebtedness were issued by SAVAGE to petitioner or HAYNES for advances made by them to SAVAGE and no interest was paid by SAVAGE to petitioner or HAYNES on said advances.

21. Due to the insolvency of SAVAGE, petitioner charged off its advances to SAVAGE, totaling $497,265.83, as a bad debt in 1963.

22. The advances which petitioner made to SAVAGE, totaling $497,265.83, constituted contributions to capital which became totally worthless during taxpayer's fiscal year ending November 30, 1963.

REASONS FOR GRANTING THE WRIT

I.

THE DECISION BELOW CONFLICTS WITH THE INTENTION OF CONGRESS TO PROVIDE A RELIEF PROVISION IN CASES INVOLVING COMPLETE WORTHLESSNESS OF INVESTMENTS IN AFFILIATED CORPORATIONS

The legislative history of Section 165(g)(3) of the 1954 Code reveals a Congressional policy to afford relief to taxpayers suffering losses from the worthlessness of securities in corporations wholly owned, or substantially wholly owned (*i.e.*, at least 95 percent), by such taxpayers.

When the provision was first enacted into law by Section 123(a), Revenue Act of 1942 (adding a new Section 23(g)(4) to the 1939 Code), the Finance Committee explained that, under pre-existing law, the losses of a parent or subsidiary could be offset against the income of its subsidiary or parent if consolidated returns were filed; and stated that the Committee deemed it "desirable and equitable" to extend the concept of disregarding the separate corporate entity to cases involving "losses attributable to the complete worthlessness of the investment in the subsidiary", and to allow the deduction of such losses as ordinary losses, rather than capital losses. Senate Report No. 1631, 77th Cong., 2d Sess., pp. 46-47, 89.

Congress further liberalized the treatment of losses from the complete worthlessness of investments in securities of subsidiaries by enacting two exceptions to the "90% of gross income" rules contained in Section 23(g)(4)(B) of the 1939 Code. See Section 112(a), Revenue Act of 1943; explained by Senator Davis, 90 Cong. Rec. 121.

In 1954, Congress again considered the provisions relating to worthlessness of stock in "affiliated corporations", leaving the 95 percent requirement for stock ownership, but liberalizing the prior "90% of gross income" rule by changing it to a requirement of "90% of gross receipts." See House Report No. 1337, 83rd Cong., 2nd Sess., pp. 21, A 46-47; 189-199; Senate Report No. 1633, 83rd Cong., 2nd Sess., pp. 198-199; House Report No. 2543, 83rd Cong., 2nd Sess. (Conference Report), pp. 28, 73.

It thus appears that Congress was well aware of various problems relating to Section 165(g)(3) of the 1954 Code and its predecessor provisions, but did not see fit to enact any restrictive rules as to "each class of stock"—specifically, any arbitrary rule that, when alleged debt was found by the Courts to be an investment in capital, a second class of stock was automatically created.

The entire legislative history of Section 165(g)(3) points to a liberal allowance of ordinary loss deductions in cases of worthlessness of stock in subsidiary corporations, rather than to a harsh and restrictive construction by the Courts.

Relief measures in the Internal Revenue Code should not be construed as "strait jackets" into which taxpayers are to be forced at the penalty of forfeiture of loss deductions. See *Granite Trust Co. v. United States*, 238 F.2d 670, 675 (1 Cir. 1956).

It is well established that (*Mertens, Law of Federal Income Taxation* (1970 Rev.), Vol. 1, Sec. 309):

> "* * * relief or remedial provisions must be liberally construed to effectuate the objectives sought. Thus a statute intended to relieve persons of hardships should be construed in favor of those who are intended beneficiaries."

With respect to liberal construction of relief provisions in the revenue laws, see also *Bonwit Teller & Co. v. United States*, 283 U.S. 258, 263 (1931); *Burnet v. Marston*, 57 F.2d 611, 612 (U.S. App. D.C. 1932).

II.

THE DECISION BELOW REPRESENTS AN ARBITRARY RESTRICTION OF THE STATUTORY PROVISION, AND IS ALSO INCONSISTENT WITH COURT DECISIONS CONSTRUING ANALOGOUS PROVISIONS DEFINING SUBCHAPTER S "SMALL BUSINESS CORPORATIONS".

The decision of the Tax Court, affirmed per curiam by the Court of Appeals, seems to hold flatly that an ordinary loss deduction under Section 165(g)(3) is never allowable, in cases where alleged debt has been converted to a capital contribution by operation of law, except when the corporation making the advances owns 100 percent of the stock of the corporation receiving the advances.[1]

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[1] The Tax Court relies rather heavily on the technicality that 20 percent of the originally authorized stock of Savage had already been issued to others. But it is obvious that, under State law, Savage's corporate charter could easily have been amended, by two-thirds vote of the shareholders, to increase its authorized capital stock sufficiently to enable the issuance to the petitioner of well over 95% thereof in consideration of its advances to Savage;

This is the only possible distinction between the present case and *Gussow, Kahn & Co.*, 13 T.C. 580 (1949), *Acq.* 1950-1 C.B. 3. In that case, as in the present one, it clearly was the intention both of the corporation advancing the funds and of the corporation receiving the advances that a debtor-creditor relationship was to be created. Nevertheless, as in the instant case, the Tax Court held that the advances were not loans and, therefore, were not deductible as bad debt losses.

The Tax Court in the *Gussow, Kahn* case did allow—through the operation of a legal fiction to the effect that the taxpayer owned stock in an "affiliated corporation" (a corporation which had never actually issued any stock)—an ordinary loss deduction under Section 23(g)(4) of the 1939 Code, which is practically identical to the present Section 165(g)(3) of the 1954 Code.

The only difference in material facts between *Gussow, Kahn & Co., supra*, and the present case is that here the petitioner, in legal effect and by operation of a legal fiction (capital contribution vs. debt), owned over 95 percent but less than 100 percent of the stock of Savage, while there the taxpayer, through the same sort of legal fiction, owned 100 percent of the stock of the subsidiary.

This is a distinction without a real difference. To refuse to apply the principles of *Gussow, Kahn & Co., supra*, to the present case is, in effect, to amend the statute and to restrict its application to cases of 100

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and it is noteworthy that both Haynes Construction Company, Incorporated, and the petitioner had substantially increased their authorized capital stock in this manner—see statement of facts, pars. 4 and 9, pp. 00-00, *supra*. West Virginia Code (1966) §§31-1-11, 31-1-12, and 31-1-13 (Appendix D hereto).

percent stock ownership, contrary to the intention of Congress–which has established 95 percent ownership as the test.

The Commissioner has not even made such a provision in his Regulations (§ 1.165-5), and if he had attempted to do so he would have exceeded his power in the administration of the Federal tax laws, which is not the power to make law but is only the power to carry into effect the will of Congress as expressed by the statute. *Manhattan Co. v. Commissioner*, 297 U.S. 129 (1936).

A regulation may not alter or amend the revenue law, *Morrill v. Jones*, 106 U.S. 466 (1883); nor extend a statute or modify its provisions, *Campbell v. Galeno Chemical Co.*, 281 U.S. 599 (1930); nor may it take away any rights and privileges which the Congress has given, *Russell Manufacturing Co. v. United States*, 175 F. Supp. 159 (Ct. Cl. 1959); nor can it impose or add a condition which Congress did not impose, unless such condition is necessary to make effective the conditions imposed by Congress, *Philadelphia Electric Co. v. United States*, 117 F. Supp. 424 (Ct. Cl. 1954).

Where a regulation is an amendment or modification of the statute and, therefore, beyond the power of the Commissioner to make, Courts must refrain from giving it effect, *Louisville Gas & Electric Co., v. United States*, 148 Ct. Cl. 671 (1960).

A fortiori, the Commissioner lacks the power to amend the Internal Revenue Code simply by taking a position in litigation–unsustained even by language in the Treasury Regulations–which unduly and unreasonably restricts the deduction under Section 165(g)(3) by a strained or overly technical construction of the "each class of stock" requirement.

Furthermore, the Tax Court's opinion (affirmed per curiam by the Court of Appeals) conflicts directly with its own recent line of decisions and the decisions of other Courts interpreting the "one class of stock" provision in connection with the definition of a Subchapter S "Small Business Corporation", under Section 1371(a) of the 1954 Code. This section defines such a corporation as a domestic corporation which, *inter alia*, "does not * * * have more than one class of stock."

Treasury Regulations § 1.1371-1(g) formerly provided that (T.D. 6432, December 18, 1959, as amended by T.D. 6667, July 29, 1963, last sentence):

> "If an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock."

In *W.C. Gamman*, 46 T.C. 1, 6-8 (1946) *appeals dismissed pursuant to stipulation* (9 Cir. 1967), the Tax Court found that the above-quoted sentence of the Regulations "appears to enlarge the scope of the statutory provision by providing that if an instrument in the form of a debt obligation actually represents equity capital, it constitutes a second class of stock and it disqualifies the corporation under Subchapter S"; and held that "we find nothing in the law itself, the committee reports, or the assumed purpose of the legislation that would justify holding, arbitrarily and per se, that all instruments which purport to be debt obligations but which in fact represent equity capital, must be treated as a second class of stock for purposes of section 1371."

After the *W.C. Gamman* decision, *supra*, Treasury Regulations § 1.1371-1(g) was amended to provide that:

"Obligations which purport to represent debt but which actually represent equity capital will generally constitute a second class of stock."

Even this amended form of the Regulations was held to be invalid, in *Amory Cotton Oil Company v. United States*, 320 F. Supp. 951 (N.D. Miss. 1970).

See also *James L. Stinnett, Jr.*, 54 T.C. 221 (1970); *Portage Plastics Company, Inc. v. United States*, 301 F. Supp. 684 (W.D. Wis. 1969); *H.R. Spinner Corporation*, T.C. Memo. 1970-99, 29 TCM 462 (1970).

As in the above-cited Subchapter S cases, the position taken by the Commissioner, and sustained by the decisions below, represents an attempted amendment of Section 165(g)(3), rather than a permissible interpretation of that statutory provision.

The Courts below have exceeded their judicial authority of interpreting the statute, and have invaded the province of Congress, by upholding the Commissioner's determination, arbitrarily and per se, that the petitioner's advances to Savage created a second class of stock, simply because individual stockholders held a miniscule percentage of the stock of Savage, which had been issued prior to the time that the Court of Appeals held that the petitioner's advances to Savage, totaling $497,265.83, constituted contributions to capital, rather than bona fide debt transactions as intended by the parties.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Fourth Circuit.

Respectfully submitted,

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APPENDIX A

T.C. Memo. 1971-170

[Filed July 20, 1971]

SUPPLEMENTAL MEMORANDUM FINDINGS OF FACT AND OPINION

This case is now before this Court on remand from the United States Court of Appeals for the Fourth Circuit. Our original opinion (see T.C. Memo. 1967-187, filed September 26, 1967, based on which a decision was entered on December 21, 1967), was vacated by the Court of Appeals in order for us to consider an argument raised by petitioner for the first time before the Court of Appeals and not previously presented to this Court for decision. *Road Materials, Inc. v. Commissioner*, 407 F.2d 1121 (C.A. 4, March 5, 1969).[1]

In our original opinion we held that certain advances of petitioner totaling $497,265.83 to Savage Construction Company, Inc. which became completely worthless in 1963, the taxable year at issue, "were not loans

[1] In its original opinion, promulgated March 5, 1969, the Court of Appeals announced that "the judgment of the Tax Court is affirmed, and * * * remanded for further proceedings * * *." On May 5, 1969 the Court of Appeals modified its opinion, stating that the judgment of this Court was "vacated" rather than "affirmed." This was done in order to allow respondent time to consider a Petition to the Supreme Court for a writ of certiorari in the taxpayer's appeal to the Court of Appeals and, at the same time, to assure that the judgment of this Court would not become final within the meaning of section 7481(2)(A), I.R.C. 1954 if respondent did not petition the Supreme Court for certiorari and thereby put this case beyond this Court's power to take the further action envisioned by the Court of Appeals' mandate.

creating a bona-fide debtor-creditor relationship and that, therefore, respondent did not err in his determination that a deduction of the total amount of such advances as a bad debt [under section 166(a)(1), I.R.C. 1954] should be disallowed." [2] The Court of Appeals held that our disposition of the issue before us was correct. Furthermore, our original findings of fact were in no way disturbed by the Court of Appeals.

In remanding this case to this Court, the Court of Appeals stated: [407 F.2d at 1125-1126]

> The taxpayer claims in this court for the first time that if the $497,265.83 is not deductible as a bad debt, it should be considered an ordinary loss because the investment was in securities of an affiliated corporation within the meaning of Int. Rev. Code of 1954 Sec. 165(g)(3) [26 U.S.C. sec. 165(g)(3)(1967)]. This issue raises factual and legal questions that should be considered in the first instance by the Tax Court, and to that end we remand.

Thus the sole issue which we must decide, as stated by the Court of Appeals and as narrowed by the parties, is whether "at least 95 percent of each class of [Savage Construction Company's] stock [was] owned directly by [petitioner] within the meaning of section 165(g)(3)(A), I.R.C. 1954.[3]

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[2] In our original opinion we also decided that petitioner was not subject to the accumulated earnings tax, section 531 *et seq.*, I.R.C. 1954.

[3] Hereafter all statutory references are to the Internal Revenue Code of 1954, unless otherwise indicated.

A conference was held with counsel for the parties on October 8, 1969 to consider what further proceedings would be taken. The parties agreed that the issue to be decided herein would be submitted for decision on the record already before this Court with the addition of certain stipulated documents. An additional stipulation was filed, and both parties have filed original and reply briefs directed to the issue presently before this Court.

SUPPLEMENTAL FINDINGS OF FACT

The facts giving rise to this issue are set out in our original opinion, T.C. Memo. 1967-187. There follows a summary of those facts, together with our fresh findings.

C.N. Haynes is a president and principal stockholder of two family corporations: Road Materials, Inc., the petitioner, and Haynes Construction Company, hereinafter referred to as "Haynes." Both corporations are engaged in the road construction business.

During the years in issue, petitioner was primarily engaged in the laying of stone base and asphaltic concrete, commonly described as black-top, on roads and highways. The asphaltic concrete used by petitioner in its construction work is transported in insulated trucks from its stationary asphalt plant in Bluefield, West Virginia, to various construction sites. Because the asphaltic concrete had to be laid at 275 degrees, the petitioner could not work further than 50 miles from its plant.

Haynes was primarily engaged in heavy road construction, which included the grading of roads and laying concrete thereon and which occasionally included bridge building and drainage systems. Haynes was qualified to do business in the States of West Virginia, North Carolina, Tennessee, Virginia, and Kentucky.

Haskell Savage was hired by Haynes as its general superintendent in charge of all its heavy construction work in 1957. He proved to be such a valuable employee to Haynes that the Haynes family decided to offer him an opportunity to acquire partial ownership in the family road construction business. Because of the size of the capitalization of Haynes and the limited amount of the funds available to Haskell for investment, it was impossible for Haskell to acquire an equity interest in Haynes large enough to serve as an incentive to his continued employment. To remedy this, on March 3, 1960 the Haynes family and Haskell formed a new corporation, Savage Construction Company, Inc. (hereinafter referred to as Savage), under the laws of West Virginia. It was envisioned that Savage would work with Haynes on joint ventures consisting of construction jobs in West Virginia, while Haynes would carry on construction contracts in Tennessee, Virginia and North Carolina. Savage and Haynes did in fact work jointly on seven projects, all outside the operating range of petitioner.

The total authorized capital stock of Savage was $50,000 consisting of 5,000 shares at a par value of $10 per share. The Certificate of Incorporation of Savage did not provide for the issuance of more than one class of stock in that company.[4] One thousand shares of the par

[4] A certified copy of the Certificate of Incorporation of Savage was attached to the additional stipulation filed by the parties for the purpose of these proceedings on remand. An amendment to Savage's Certificate of Incorporation was attached to the stipulation. This amendment changed Savage's name from "Savage Construction Company, Inc." to "Savage Construction Company of Bluefield, Inc.", but made no other changes.

value of $10,000 were issued to the following persons, each of whom purchased and held the shares on his or her own behalf and not as agent for or on behalf of any person or entity, including petitioner: [5]

C.N. Haynes, President	490 shares
Hazel S. Haynes, Secretary-Treasurer	20 shares
A.C. Haynes, Vice President	70 shares
J.J. Chase	70 shares
Haskell Savage	350 shares

When Savage was incorporated, C.N. Haynes advanced to it the amount of $10,000 which was carried on the books of Savage as a loan.

From August 31, 1961 through August 31, 1963, C.N. Haynes arranged for the petitioner to advance $497,265.83 to Savage without security and without the execution of a note or other written evidence of indebtedness. The advances were shown on the petitioner's books as "loans" and were entered on the books of Savage as items payable to affiliated companies. There was no agreement by Savage to repay any of the advances on a date certain or within a reasonable time. Petitioner made no demand for interest or repayment of principal, and none was paid.

During the years 1960 through 1963 Haynes also made certain cash advances and payments to or on behalf of Savage, and received certain payments from Savage to or on behalf of itself. Haynes at no time owed money to Savage. These advances and repayments between Haynes and Savage were treated in the same manner as the advances from petitioner to Savage, i.e., there were no

[5]Hazel S. Haynes is the wife of C.N. Haynes and A.C. Haynes is the brother of C.N. Haynes, J.J. Chase had been a shareholder in Haynes since 1959.

notes or other written evidence of indebtedness and there was no agreement to repay any of the advances on a date certain or within a reasonable time, instead they were merely shown on the books of Haynes and Savage as amounts receivable or amounts payable. Including an item described by petitioner as "Notes and Accounts payable Rish Equipment Co. by Savage consolidated in new notes of Jan. 21, 1963 Haynes to Rish with Savage as Co-Signer" in the amount of $436,164.18, the balance due from Haynes to Savage on December 31, 1963 was the sum of $846,781.49. Advances between petitioner and Haynes, treated in the same manner as the advances described above, had been made during the years 1957 through 1963. On its balance sheet for its fiscal year ended November 30, 1963, petitioner listed a sum of $415,607.79 as being due from Haynes; on Haynes' balance sheet for its fiscal year ended December 31, 1963, Haynes listed a sum of $385,607.79 as being due to petitioner.

ULTIMATE CONCLUSION

At no time during the year 1963 or in prior years did petitioner Road Materials, Inc., directly own, or have a right to subscribe for or to receive, at least 95 percent of each class of stock of Savage.

OPINION

TIETJENS, *Judge*: The sole issue presented on this remand is whether petitioner's loss is an ordinary loss as a result of the applicability of section 165(g)(3), rather than a capital loss. Section 165(g), as applicable to this case in pertinent part, reads as follows:

SEC. 165(g). Worthless Securities.–

(1) General rule.–If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

* * * * *

(3) Securities in affiliated corporation.– For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if–

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

We held in our original opinion in this case (T.C. Memo. 1967-187), and the Court of Appeals agreed (407 F.2d 1121, 1123-1125), that petitioner's advances to Savage did not constitute a debt within the meaning of section 166(a)(1). It is undisputed that Savage had no disqualifying income of the type specified in section 165(g)(3)(B), and that both petitioner and Savage are domestic corporations. It is undisputed that petitioner

sustained a loss due to the complete worthlessness of its advances to Savage in 1963 as a result of Savage's insolvency occurring in that year. (The parties also appear to have agreed that the advances from Haynes to Savage are to be treated as a bona fide debt of Savage.)[6] The only question we must decide is whether, on the facts presented, petitioner can be considered to be the direct owner of at least 95 percent of each class of Savage's stock within the meaning of section 165(g)(3)(A).

As we understand petitioner's argument, it begins with the following syllogism. Petitioner's major premise in its syllogism is that it owned "securities" of Savage as that term is defined in section 165(g)(2)(B) in the total amount of its advances to Savage ($497,265.83). Petitioner's minor premise is a proposition to be inferred from an examination of the Certificate of Incorporation of Savage, that Savage was authorized to issue only one class of stock. Petitioner then concludes that the "securities" it owned in Savage were the equivalent of the one class of stock which Savage was authorized to issue. Because, petitioner adds, petitioner's advances of $497,265.83 were the only contributions to Savage's capital apart from the cash payments of $10,000 made by Savage's individual shareholders who purchased 1,000 shares of the capital stock of Savage (and possibly also the additional amount of $10,000 advanced to Savage by C.N. Haynes when Savage was incorporated), petitioner owned more than the necessary minimum of 95 percent of Savage's one class of stock and therefore is entitled to an ordinary loss deduction under section 165(g)(3). In

[6](While this apparent concession by the respondent also may not have been a foregone conclusion based upon the facts on this record see, in this regard, T.C. Memo. 1967-187, 26 T.C.M. 922, 930, par. 67, 187 P-H Memo. T.C., page 1016-67.)

support of its position herein, petitioner relies on *Gussow, Kahn & Co.*, 13 T.C. 580; and on *Byerlite Corp. v. Williams*, 170 F. Supp. 48 (N.D. Ohio), reversed on another issue, 286 F.2d 285 (C.A. 6).

Respondent's primary position is as follows: pursuant to our finding in our original opinion in this case that the advances from petitioner to Savage were made solely to promote the business of the Haynes family, these advances represented dividends to petitioner's common stockholders and contributions by them to the capital of Savage, and therefore these advances cannot be characterized as petitioner's capital investments in Savage. Respondent also contends that, whether or not this Court accepts his primary position, the advances constitute another class of stock with rights different from the 1,000 shares issued to the original individual stockholders.

We do not think it necessary to agree with the position by respondent in these arguments in order to decide this case against petitioner.

Petitioner relies heavily on *Gussow, Kahn & Co., supra.* We think the facts there render that case distinguishable from the case before us. In the *Gussow, Kahn & Co.* case, the taxpayer corporation caused the organization of a subsidiary corporation and advanced to it all of the funds which the subsidiary was to use in its unsuccessful business endeavors. These advances were treated by both the taxpayer and the subsidiary as loans. At no time did the subsidiary issue any of its stock, and no person or corporation other than the taxpayer had any financial interest in the subsidiary. In our opinion in the *Gussow, Kahn & Co.* case we concluded that the taxpayer in that case "had the legal right to direct the issuance to itself of

all of the authorized capital stock of [the subsidiary] and, *in legal effect*, therefore, [taxpayer] directly owned * * * 100 percent of [the subsidiary's] stock." (13 T.C. at 584) [Emphasis is added.] Accordingly, we held that the subsidiary was an affiliated corporation of the taxpayer within the meaning of the 1939 Code predecessor to section 165(g)(3).[7]

In contrast to the taxpayer in the *Gussow, Kahn & Co.* case, the petitioner in the instant case has failed to convince us that it ever had the *legal right* to cause Savage to issue to it any stock of the same class as that owned by Savage's individual shareholders. Under the present facts, we can reach no conclusion other than that petitioner never owned and never had a right to subscribe for, or to receive, any of Savage's common stock. We so hold. See *Northeastern Consolidated Co. v. United States*, 406 F.2d 76, 79 (C.A. 7, 1969), where it was said:

> Under § 165(g)(3)(A), "a corporation shall be treated as affiliated with the taxpayer only if–(A) at least 95 percent of each class of its stock is owned directly by the taxpayer * * *" In the instant case, although taxpayer *owned an equity investment in Necco, that investment was not in Necco's common stock.* It is undisputed that Donnelly and Schmidt owned 100 percent of that class and thus Necco was not, under the statutory definition, affiliated with taxpayer since taxpayer did not own at least 95 percent of each class. [Emphasis supplied.]

Here, even though we were to decide that petitioner by reason of its advances, held the right to acquire all of the

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[7] The facts and the result in *Byerlite Corp. v. Williams, supra*, also relied upon by petitioner were the same except that six shares of the subsidiary's stock were issued to the taxpayer in return for a payment of $30.

unissued stock of Savage, we note that Savage's authorized stock was 5,000 shares at a par value of $10 per share. One thousand of these shares (20%) had already been issued to others than Savage, so that if we held that petitioner had the right to subscribe to the remaining 4,000 shares and that the remaining shares would be of the same class as those issued to the other original stockholders, petitioner would still fall short of meeting the statutory test applicable to the tax years in question, that "at least 95 percent of each class of its stock is owned directly by the taxpayer. * * *."

This is the basis for our decision. Petitioner had an equity investment in Savage but did not directly own "at least 95 percent of each class of stock."

We are convinced that within the meaning of section 165(g)(3) petitioner did not own "at least 95 percent of each class of [Savage's] stock."Petitioner does not suggest that the advances from petitioner to Savage entitled petitioner to any right to vote or otherwise to participate in the management of Savage's affairs. Nor does petitioner maintain that petitioner was to participate in the earnings or growth of the business; in fact, it was originally contemplated by Savage's individual stockholders that they, rather than the petitioner corporation, would reap the benefits of Savage if it were a successful enterprise. It was for this reason that petitioner's advances to Savage were characterized as, and intended to be, debt. It appears that petitioner argued before the Court of Appeals that its advances to Savage were in a form which West Virginia law recognizes as debt. 407 F.2d, at 1124. Petitioner does not now in this Court argue to the contrary.

Petitioner urges, citing legislative history of section 23(g)(4), I.R.C. 1939 (predecessor to section 165(g)(3))

not pertinent to the question before us, that section 165(g)(3) and its predecessor are relief provisions, and a liberal construction of those sections is to be favored by this Court "permitting the allowance as ordinary loss deductions of losses due to the worthlessness of investments in substantially wholly owned subsidiaries." We agree with petitioner that section 165(g)(3) and its predecessor were intended as relief measures, but we disagree wtih petitioner's statement as to their scope. As we read these sections and their legislative history, we think that the Congressional motive behind their enactment was to provide relief to domestic corporations whose stock in a wholly owned subsidiary became totally worthless under the narrow circumstances where the parent corporation could have filed consolidated returns with the subsidiary, but did not do so. See S. Rept. No. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 543; H. Rept. No. 1337, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess., pp. 21, A47 (1954); S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. 591) 83d Cong., 2d Sess., pp. 24, 199 (1954). We have taken into account the fact that the language of sections 165(g)(2) and 165(g)(3) differs from the language of section 1504(a),[8]

[8]SEC. 1504(a). Definition of "Affiliated Group".—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

(1) Stock possession at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all

set forth in the margin, which basically defines "affiliated group" for purposes of filing consolidated returns. Still we find no compelling reason in the language of sections 165(g)(2) and 165(g)(3) or in their legislative history to recast the debt form of petitioner's advances to Savage into the "common stock" form proposed by petitioner.

In view of our holding, we shall enter a decision in all material respects similar to the decision originally entered by this Court on December 21, 1967.

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classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 71-2048

Road Materials, Inc.,

Appellant,

v.

Commissioner of Internal Revenue,

Appellee.

Appeal from the Tax Court of the
United States, at
Washington, D.C.

Argued March 7, 1972. Decided April 4, 1972.

Before Haynsworth, Chief Judge,
and Bryan and Field,
Circuit Judges.

Richard L. Hirshberg (LeRoy Katz and Katz, Katz, and Kantor on brief) for Appellant, and Murray S. Horwitz, Attorney, Tax Division, Department of Justice, (Scott P. Crampton, Assistant Attorney General, Meyer Rothwacks. Elmer J. Kelsey, Attorneys, Tax Division, Department of Justice, on brief) for Appellee.

Per Curiam:

On the opinion of the Tax Court, we affirm denial of the ordinary loss deduction under §165(g)(3) of the Internal Revenue Code of 1954.

Affirmed.

APPENDIX C

INTERNAL REVENUE CODE OF 1954
INCOME TAX

§165. Losses

* * * * *

(g) Worthless securities.–

(1) **General rule.**– If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) **Security defined.**– For purposes of this subsection, the term "security" means–

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) **Securities in affiliated corporation.**– For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if–

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources

other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

* * * * *

TREASURY REGULATIONS
COMPUTATION OF TAXABLE INCOME

§ 1.165-5. Worthless securities

(a) **Definition of security.** As used in section 165(g) and this section, the term "security" means:

(1) A share of stock in a corporation;

(2) A right to subscribe for, or to receive, a share of stock in a corporation; or

(3) A bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

(b) **Ordinary loss.** If any security which is not a capital asset becomes wholly worthless dur[illegible]he taxable year, the loss resulting therefrom may b[illegible]ducted under section 165(a) as an ordinary loss.

(c) **Capital loss.** If any security which is a capital asset becomes wholly worthless at any time during the taxable year, the loss resulting therefrom may be deducted under section 165(a) but only as though it were a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1). The amount so allowed as a deduction shall be subject to the limitations upon capital losses described in paragraph (c)(3) of §1.165-1.

(d) **Loss on worthless securities of an affiliated corporation— (1) Deductible as an ordinary loss.** If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of sub-paragraph (2) of this paragraph and such security becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with paragraph (b) of this section. The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, since section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1). A debt which becomes wholly worthless during the taxable year shall be allowed as an ordinary loss in accordance with the provisions of this sub-paragraph, to the extent that such debt is a security within the meaning of paragrpah (a)(3) of this section.

(2) **Affiliated corporation defined.** For purposes of this paragraph, a corporation shall be treated as affiliated with the taxpayer owning the security if:

(i) The taxpayer owns directly at least 95 percent of each class of stock of such corporation,

(ii) None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g)(3), and

(iii) More than 90 percent of the aggregate of the gross receipts of such corporation for all the taxable years during which it has been in existence has been from sources other than royalties, rents (except rents derived from rental of properties to employees of such corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. For this purpose, the term "gross receipts" means total receipts determined without any deduction for cost of goods sold, and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains from such sales or exchanges.

(e) **Bonds issued by an insolvent corporation.** A bond of an insolvent corporation secured only by a mortgage from which nothing is realized for the bondholders on foreclosure shall be regarded as having become worthless not later than the year of the foreclosure sale, and no deduction in respect of the loss shall be allowed under section 165(a) in computing a bondholder's taxable income for a subsequent year. See also paragraph (d) of § 1.165-1.

(f) **Decline in market value.** A taxpayer possessing a security to which this section relates shall not be allowed any deduction under section 165(a) on account of mere market fluctuation in the value of such security. See also § 1.165-4.

(g) **Application to inventories.** This section does not apply to any loss upon the worthlessness of any security reflected in inventories required to be taken by a dealer in securities under section 471. See §1.471-5.

(h) **Special rules for banks.** For special rules applicable under this section to worthless securities of a bank, including securities issued by an affiliated bank, see §1.582-1.

(i) **Examples.** The provisions of this section may be illustrated by the following examples:

Example (1). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 10 percent of each class of the stock of Y Corporation; and, in addition, 4 percent of the common stock (the only class of stock) of Z Corporation, which it acquired in 1948. Y Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year owns 96 percent of the common stock of Z Corporation, which it acquired in 1946. It is established that the stock of Z Corporation, which has from its inception derived all its gross receipts from manufacturing operations, became worthless during 1956.

(ii) Since the stock of Z Corporation which is owned by X Corporation is a capital asset and since X Corporation does not directly own at least 95 percent of the stock of Z Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1956, of a capital asset. The loss so sustained by X Corporation shall be considered a long-term loss under the provisions of section 1222(4),

since the stock was held by that corporation for mor than 6 months.

(iii) Since Z Corporation is considered to be affiliate with Y Corporation under the provisions of paragrap (d)(2) of this section, any loss sustained by Corporation upon the worthlessness of the stock of Corporation shall be deducted in 1956 under sectio 165(g)(3) and paragraph (d)(1) of this section as a ordinary loss.

Example (2). (i) On January 1, 1956, X Corporation, domestic manufacturing corporation which makes it return on the basis of the calendar year, owns 80 percen of each class of the stock of Y Corporation, a foreig corporation, which it acquired in 1950. Y Corporatio has, from the date of its incorporation, derived all of it gross receipts from manufacturing operations. It i established that the stock of Y Corporation becam worthless on June 30, 1956. On August 1, 1956, Corporation acquires the balance of the stock of Corporation for the purpose of obtaining the benefit o section 165(g)(3) with respect to the loss it has sustaine on the worthlessness of the stock of Y Corporation.

(ii) Since the stock of Y Corporation which is owne by X Corporation is a capital asset and since Corporation is not to be treated as affiliated with Corporation under the provisions of paragraph (d)(2) o this section, notwithstanding the fact that, at the close o 1956, X Corporation owns 100 percent of each class o stock of Y Corporation, any loss sustained by Corporation upon the worthlessness of such stock sha be deducted under the provisions of section 165(g)(1 and paragraph (c) of this section as a loss from a sale o exchange on December 31, 1956, of a capital asset.

Example (3). (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year owns 95 percent of each class of the stock of Y Corporation, which from its inception has derived all of its gross receipts from manufacturing operations. As one of its capital assets, X Corporation owns $100,000 in registered bonds issued by Y Corporation payable at maturity on December 31, 1960. It is established that these bonds became worthless during 1956.

(ii) Since Y Corporation is considered to be affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by X Corporation upon the worthlessness of these bonds may be deducted in 1956 under section 165(g)(3) and paragraph (d)(1) of the section as an ordinary loss. The loss may not be deducted under section 166 as a bad debt. See section 166(e).

* * * * *

APPENDIX D

Michie's West Virginia Code

§31-1-11. Amendment of charter.

Every corporation of this State heretofore or hereafter incorporated may, from time to time and in the manner herein provided, when and as desired, amend its charter by addition to its corporate powers and purposes, or diminution thereof, or both; or by substitution of other powers and purposes, in whole or in part, for those set forth in its charter; or by increasing or decreasing its authorized capital stock or classifying or reclassifying the same, by changing the number, par value, designations, preferences, or relative, participating, optional, or other special rights of the shares, or the qualifications, limitations or restrictions of such rights, or by changing shares with par value into shares without par value or shares without par value into shares with par value either with or without increasing or decreasing the number of shares; or by changing its corporate name, or by making any other change or alteration in its charter that may be desired; and any or all such changes or alterations may be effected by one amendment: Provided, that every charter as so amended, changed or altered, shall contain only such provisions as it would be lawful and proper to have in an original agreement of incorporation made at the time of making such amendment.

Whenever issued shares having par value are changed into the same or a greater or less number of shares without par value, whether of the same or of a different class or classes of stock, the aggregate amount of the capital of the corporation represented by such shares without par value shall be the same as the aggregate amount of capital represented by the shares so changed; and whenever issued shares without par value are changed

into other shares without par value to a greater or lesser number, whether of the same or of a different class or classes, the amount of capital represented by the new shares in the aggregate shall be the same as the aggregate amount of capital represented by the shares so changed; and the amendment of the charter of the corporation effecting any such change shall set forth that the capital of the corporation will not be reduced under or by reason of such amendment. (1863, c. 105; Code 1868, c. 53, §§ 12, 13; c. 54, §§ 10, 13, 21, 22; 1881, c. 17; 1882, cc. 96, 97; 1901, c. 35; Code 1923, c. 53, § 12; c. 54, §§ 10, 13, 21; 1935, c. 25; 1959, c. 20).

§ 31-1-12. How amendments made; issuance and recordation of certificate of amendments.

Except as hereinafter in this section provided, a resolution or resolutions specifically stating the proposed amendment or amendments shall be adopted by a majority vote of all of the shares of capital stock of the company entitled to vote at a regular or special meeting of the stockholders, and notice of such meeting shall be given as provided by the by-laws of the corporation, or, in the absence of a provision in the by-laws for such notice, in the manner provided in this article. The notice to stockholders shall inform them of the amendments of the charter proposed to be made and that the stockholders at the meeting will vote upon the question or questions of making such amendments: Provided, however, that if the corporation have only one class of stock, and any such amendment would increase or decrease the amount of the authorized capital stock, or would increase or decrease the par value thereof, then the affirmative vote of two thirds of all the stockholders shall be necessary to the adoption thereof: Provided

further, that if the corporation have more than one class of stock, and if any such proposed amendment would alter or change the preferences given to any one or more classes of stock, by the charter, or would increase or decrease the amount of the authorized stock of such class or classes of stock, or would increase or decrease the par value thereof, then the holders of the stock of each class of stock affected by the amendment shall be entitled to vote as a class upon such amendment, whether by the terms of the charter such class be entitled to vote or not, and the affirmative vote of two thirds in interest of each such class of stock affected by the amendment shall be necessary to the adoption thereof, in addition to the affirmative vote of a majority of every other class of stock entitled to vote thereon: Provided further, that the amount of the authorized stock of any such class or classes of stock if more than one class exists, or if only one class that class of stock, may be increased or decreased by the affirmative vote of the holders of a majority of the stock of the corporation entitled to vote, if so provided in the original charter or in any amendment thereto which created such stock, or class or classes of stock, or in any amendment thereto which was authorized by a resolution or resolutions adopted by the affirmative vote of the holders of two thirds of such stock, or class or classes of stock: And provided further, that any amendment to the charter under a right reserved therein to make such amendment may be made in the manner specified in the charter and by a vote of the proportion of the shares of outstanding stock and of the class or classes of stock authorized to amend, as set out in the charter.

The president or a vice president of the corporation, under his signature and the seal of the corporation, shall

certify the resolution or resolutions and the fact and the manner of the adoption of the same, and of the assenting of all stockholders, the consent of whom is required under this article to the making of such amendment, or amendments, to the secretary of state, who shall issue his certificate reciting such resolution, corporate action and facts certified in like manner and with like effect as an original certificate of incorporation and transmit the same to the corporation. Such certificate or a certified copy thereof shall be recorded and received in evidence as provided for the recordation and admission in evidence of an original certificate of incorporation or a certified copy of such original. Such certificate shall declare the changes or amendments as in effect from the date thereof. (1863, c. 105; Code 1868, c. 53, §§ 12, 13; c. 54, §§ 10, 21, 22; 1881, c. 17; 1882, cc. 96, 97; 1901, c. 35; Code 1923, c. 53, §§ 12, 13; c. 54, §§ 10, 21, 22; c. 54A, §16; 1955, c. 25; 1959, c. 20.)

§ 31-1-13. Increase or reduction of authorized stock.

If an increase of the authorized capital stock of any corporation shall have been duly authorized as provided in section eleven [§ 31-1-11] of this article, the amendment shall set forth:

(a) The amount of capital stock theretofore authorized;

(b) The amount of additional stock authorized;

(c) The classes, if any, into which the additional stock is to be divided, with the preferences, voting powers, restrictions and qualifications of the newly authorized shares; and

(d) The number and par value of the shares of the newly authorized stock, and, if more than one class, the number and par value of the shares of each class, and if

any new or authorized stock is of nominal or without par value that fact and the number of shares of such stock shall be stated.

If a reduction of the authorized but unissued capital stock of any corporation shall have been duly authorized as provided in section eleven [§ 31-1-11] of this article, the amendment shall set forth:

(a) The amount of capital stock theretofore authorized and the number and par value of the shares, and if more than one class, the amounts of each class and the number and par value of the shares of each class;

(b) The amount of capital stock issued and, if more than one class, the amount of each class;

(c) The amount of the reduction of authorized but unissued stock, specifying in which class or classes, if more than one class, the reduction is to be effected and the amount of the reduction of each class; and

(d) The number and par value of the shares of each class as reduced and the number of shares of stock of nominal or without par value theretofore authorized and the number of such shares of stock as reduced. (1931 Code, § 31-1-13; 1959, c. 20.)

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-372

ROAD MATERIALS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The *per curiam* opinion of the court of appeals (Pet. App. B) is not yet reported. The findings of fact and opinion of the United States Tax Court (Pet. App. A) are reported at 30 T.C.M. 728.

JURISDICTION

The judgment of the court of appeals was entered on April 4, 1972. (Pet. App. B.) By order dated June 30, 1972, Mr. Chief Justice Burger extended the time for filing a petition for a writ of certiorari to and including September 1, 1972. (Pet. 2.) The petition was filed

September 1, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly held that petitioner did not directly own at least 95 percent of each class of stock of another corporation to which it had made advances, and that, consequently, petitioner's losses did not qualify for an ordinary loss deduction under Section 165(g)(3) of the Internal Revenue Code of 1954.

STATUTE AND REGULATIONS INVOLVED

Section 165(g) of the Internal Revenue Code of 1954 (26 U.S.C., 1964 ed.) and the pertinent provisions of Section 1.165-5 of the Treasury Regulations on Income Tax (1954 Code) are set forth at Pet. App. C.

STATEMENT

Petitioner, a corporation primarily engaged in the laying of stone base and asphaltic concrete, was owned by C. N. Haynes, Hazel S. Haynes, and A. C. Haynes (Pet. 6, 7), who were also the principal owners of Haynes Construction Company, Inc. (Haynes), a corporation engaged primarily in the grading of roads and laying of concrete (Pet. 6-8). Haynes employed Haskell Savage as its general superintendent in charge of heavy construction work. Savage proved to be such a valuable employee to Haynes that C. N. Haynes and the other members of the family owning stock became concerned that Haskell Savage might seek employment with another construction corporation unless he were given part ownership of the business. (Pet. App. A, p. 4a.)

Because of the limited funds available to Haskell Savage for investment, it was impossible for him to acquire an equity in Haynes large enough to serve as an incentive to remain with that company. (Pet. App. A, p. 4a.) Consequently, after some discussion between C. N. Haynes and Haskell Savage, it was agreed that the latter was to have a 35-percent stock interest in a new corporation, Savage Construction Company, Inc. (Savage). Savage, which was formed on March 3, 1960 (Pet. App. A, p. 4a), had one class of stock of 5,000 shares authorized at a par value of $10 per share (Pet. 9; Pet. App. A, p. 4a). Only 1,000 shares were issued for cash. Haskell Savage received 35 percent of the issued stock, and the remaining stock was acquired by the members of the Haynes family and business associates. (Pet. 9; Pet. App. A, p. 5a.)

C. N. Haynes arranged for petitioner to advance to Savage the $497,265.83 involved here, without security and without the execution of a note or other written evidence of indebtedness. (Pet. 9, 11; Pet. App. A, p. 5a.) These advances were carried on petitioner's books as loans and were entered on Savage's books as items payable by it. (Pet. App. A, p. 5a.) Despite the way these advances were carried on the books, there was never any agreement between Savage and petitioner to repay any of the advances within a specific or reasonable time, nor was there ever any demand for interest or repayment of principal, and none was paid. (Pet. 11; Pet. App. A, p. 5a.)

In a prior proceeding, the Tax Court held that the advances did not constitute a debt within the meaning of Section 166(a)(1) of the Internal Revenue Code.

Road Materials, Inc. v. *Commissioner*, 26 T.C.M. 922. The Fourth Circuit upheld this determination, but remanded the case to the Tax Court to determine whether the loss was deductible as an ordinary loss under Section 165(g)(3), which permits an ordinary loss deduction for worthless securities in an affiliated corporation, defined at that time (see *infra*, n. 1), as a corporation in which the taxpayer owned at least 95 percent of each class of stock. *Road Materials, Inc.* v. *Commissioner*, 407 F. 2d 1121 (C.A. 4). On remand, the Tax Court found that the loss did not qualify as an ordinary loss on the ground that petitioner did not own, or have a right to receive, the prescribed 95 percent of each class of stock of Savage and, therefore, that Savage was not an affiliated corporation under Section 165(g)(3). The court of appeals affirmed *per curiam*.

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other reason for further review.

1. Generally, the loss from securities becoming worthless within a taxable year is treated as a capital loss. Section 165(g)(3), as it was in effect for the year in issue,[1] carved out an exception to this general rule by permitting a corporation an ordinary loss with respect to a security in another corporation of which it owned

[1] Section 165(g)(3)(A) was amended by the Act of January 12, 1971, P.L. 91-687, 84 Stat. 2071, for taxable years beginning on or after January 1, 1970, and now provides for an ordinary loss to a corporation with respect to a security in another corporation of which it directly owns at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of nonvoting stock.

at least 95 percent of each class of stock. See *Northeastern Consolidated Co.* v. *United States,* 406 F. 2d 76 (C.A. 7). The legislative history indicates that Congress intended Section 165(g)(3) and its predecessor to provide relief when certain very specific requirements were met. See S. Rep. No. 1631, 77th Cong., 2d Sess., p. 89; H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 21, A47; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 24. As found by both courts below, however, petitioner failed to meet the requirement of Section 165(g)(3)(A) that it own "at least 95 percent of each class of (Savage's) stock * * * ." Of the 5,000 shares of stock authorized by the certificate of incorporation, 1,000 shares were paid for and issued to persons other than petitioner. Therefore, petitioner did not own 95 percent of each class of stock as required by Section 165(g)(3)(A). *Northeastern Consolidated Co.* v. *United States, supra.* Even assuming, *arguendo,* as petitioner claims, that the advances were conditioned on the right to acquire all of the unissued stock of Savage, 20 percent had been issued to persons other than petitioner, and petitioner fell short of meeting the statutory requirement then in effect that it own 95 percent of each class of Savage's stock.[2] (Pet. App. A, p. 11a.)

2. Petitioner also contends (Pet. 17) that the decision below is inconsistent with decisions construing an analogous provision defining subchapter S "Small Business Corporations" (Section 1371 of the Internal Reve-

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[2] Petitioner appears to assume that stock ownership is measured in terms of the amount of money advanced. Section 165(g)(3)(A), however, refers to percentage of stock owned, not to the amount of value contributed.

nue Code).[3] In *Portage Plastics Co.* v. *United States*, 72-2 U.S.T.C., par. 9567 (C.A. 7, July 18, 1972), the only court of appeals which has ruled on this issue held that similar advances purporting to be debt but actually equity were a second class of stock for purposes of subchapter S. This is consistent with the decision in *Northeastern Consolidated Co.* v. *United States*, *supra*, applying Section 165(g)(3)(A), that advances which are an equity interest, although not common stock, constitute a second class of stock. In any event, this argument does not help petitioner, for even if it is deemed here to own a second class of stock, petitioner does not qualify for ordinary loss treatment under Section 165(g)(3)(A), since it did not own 95 percent of *each class* of Savage's stock.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER 1972.

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[3] *Gussow, Kahn & Co.* v. *Commissioner*, 13 T.C. 580, acquiescence, 1950-1 Cum. Bull. 3, on which petitioner relies, was persuasively distinguished by the Tax Court. (Pet. App. A, pp. 9a-10a.) In any event, a decision here inconsistent with a Tax Court case is not such a conflict as would warrant certiorari.

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